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Accounting Questions: Disposition of Items on Balance-sheets, Earnings of Fire and Casualty Insurance Companies

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Accounting Questions

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DISPOSITION OF ITEMS ON BALANCE-SHEETS

Question: I would greatly appreciate, as an associate member of the Institute, specific enlightenment as to the proper disposition on the balance-sheet recommended of such ordinary items as call loans, commercial paper, tax anticipation notes, mortgage notes, bankers acceptances and similar media for the temporary investment of current surplus corporate funds.

Answer: Your inquirer asks for enlightenment as to the proper disposition in the balance-sheet of "such ordinary items as call loans, commercial paper, tax anticipation notes, mortgage notes, bankers acceptances and similar media for the temporary investment of current surplus corporate funds." It is difficult to answer such a general inquiry as from its wording one can not well determine whether your inquirer wishes information about each of the items individually or information as to the general treatment of temporary investments of surplus funds. Assuming the latter to be the purpose of the inquiry, it is the writer's opinion that it is always proper and usually desirable to classify temporary investments of current surplus corporate funds as current assets. To justify such classification, however, it should be definitely determined that the asset actually represents a temporary investment which can be exchanged for cash whenever desired and is not intended as a permanent investment. In any case, it is desirable that the description of the asset so included among the current assets should be as clear and definite as possible.

Answer: The items listed are temporary investments of current surplus corporate funds and are properly classified on a balance-sheet as "marketable securities" and are properly included in the designation "current assets."

Answer: If this question is read carefully it would appear that an error had been made in stating it. However, we can interpret the sense of this question to mean the proper disposition on the balance-sheet of the various items set forth in the question.

A company having on hand more cash than it needs for its current purposes frequently invests these funds temporarily for the purpose of the return which is afforded by such investment. The fact that this disposition of funds is temporary makes it necessary to seek sound investments which may be liquidated without loss at the time the need for cash may arise. It is necessary to seek investments which have a ready market value or mature on or before the time when the need for cash may arise.

We understand that current assets are those assets which, in the ordinary course of business, may be converted into cash to pay liabilities without crippling or restricting the activities of the business. So long as the investments continue to be readily marketable or of an early maturity date they answer the description of current assets. It will be noted that on the balance-sheet current assets are arranged usually in their order of liquidability and for this reason cash is placed first, accounts receivable follow and inventories are placed last. These three items do not, of course, include all current assets but are merely stated for purposes of illustration. Following this practice, therefore, it is recommended that the media for the temporary investment of funds be classified on the balance-sheet in the same manner, that is, in their order of liquidability. As an illustration, call loans which supported by proper collateral are about as liquid as cash and are usually placed on the balance-sheet immediately below that item.

EARNINGS OF FIRE AND CASUALTY INSURANCE COMPANIES

Question: "In computing the earnings which accrue to a stockholder of a fire or casualty insurance company during a period of one year, the underwriting profit or loss, the net interest, dividends and rents earned, and net profit or loss on investments are added together. Some firms also include 40 per cent. of the increase in the unearned-premium reserve for the year. They justify this by stating that it reflects the increase in the liquidating value of the stock. (The liquidating value of a fire or casualty company stock is obtained by taking the capital, surplus, voluntary reserve, and 40 per cent. of the unearned premium reserve.)

"On the other hand, it is claimed that since the reserves revert to underwriting profits as soon as the policy expires, this should not be taken in computing the total earnings.

"Since taking in the 40 per cent. of the increase in U. P. R. usually tends to inflate the profits, we feel that the more conservative way is to omit that figure."

Answer: We do not believe that 40 per cent. of the unearned premium reserve should be used in computing the earnings of the company.

This would only be obtained by reinsuring the open risks, which would contemplate liquidation, and the 40 per cent. is not a fixed amount but subject to negotiation and any special conditions of the business of the company being taken over.

Usually in a fire insurance company there is also an equity in the unpaid losses, as normally there is a saving between the losses as estimated and paid. There are also possible equities in undervalued real estate, office furniture and fixtures and the goodwill value of an established agency organization. These matters would require consideration in the sale of a company but hardly in finding its earnings.

In conclusion we may point out that the state insurance departments do not permit the inclusion of the 40 per cent. in their determination of surplus.

Answer: A credit to income account of the character indicated in your letter may perhaps more clearly be described as a "part deferment of the estimated cost of acquisition of unearned premium income." No such income credit is permitted by state insurance departments to be included in annual statements filed by insurance companies, nor is it the usual practice of insurance companies to record it on their own books. If auditors, however, should find in the course of an examination that credit has been so taken they would, we consider, be justified in passing the accounts, provided the amount of deferred cost and the basis of its computation is clearly shown on the face of the balance-sheet.

The balance-sheet of any business carried on for the purpose of gain is usually prepared on the basis of the company being a "going concern," and does not attempt to reflect the liquidating value of shares owned by a stockholder in the company. In the event that an insurance company in preparing its balance-sheet follows the more usual practice of not deferring the approximate cost of acquisition of unearned premiums, the liquidating share value is less nearly reflected by the balance-sheet to the extent of the item not deferred. It may be mentioned that statistics relating to insurance companies' balance-sheets usually give effect to this deferment in the computation of share values.